DR. KURT RICHEBÄCHER

CURRENCIES AND CREDIT MARKETS

No.202/ February 1990

Muehlegasse 33
CH-8001 Zuerich
Switzerland

The chief reason for the financial confusion in the late 1920s, as in similar eras of the past, was the credit inflation. Combined with stable price levels, it generated a sense of security and an overestimation of the expansionary potential. This misled a dynamic society into recklessly speculative ventures on an unprecedented scale.

The Twilight of Gold, M. Palyi
Chicago 1972, Patient. 240

HIGHLIGHTS

In the past, when the U.S. was still a major creditor nation, the Fed could muddle through a foreign exchange crisis and still afford to give priority to domestic policy matters. What makes the situation precarious this time is the fact that interest spreads between the dollar and the hard currencies are at their narrowest in almost 20 years.

Instead of worrying about inflation in Germany, we worry more and more about stagflation in the Anglo-Saxon countries and their limited options to fight a recession.

International capital mobility is a new catchword since it is seen as the facilitating elixir that guarantees perpetual financing of deficits. The apostles of this view conveniently overlook the fact that their "new era" mechanism can cut both ways.

Capital mobility is an joy-enhancing adrenalin for a deficit country as long as it has a strong economy that can tolerate high interest rates. But capital mobility becomes a horrid hell when it faced with a weakening economy that requires easier money.

The worst possible scenario for the currencies and the financial markets of the deficit countries is when their weakening economies coincide with booming economies in the surplus countries.

If the fact be known, the dollar and the U.S. financial markets are at the mercy of the Japanese central bank and investors. The fate of the massive capital outflows from Japan are the single most important wild card for the dollar and the U.S. bond market.

The Japanese are the most reckless borrowers within the world international market, an activity which serves no other purpose than to speculate in the currencies and financial markets of other countries. So far, nobody has squawked because Japan's shenanigans have boosted asset prices around the globe.

The point to realize is that the highly fluid and liquid nature of Japan's investment in U.S. marketable securities when combined with Japan's massive dollar-base exposure virtually guarantees a highly explosive "blow-out" should ever anything go wrong.

If Japanese investors were to curtail their purchase of U.S. bonds, U.S. long-term interest rates would surely rise. Worse yet, a dumping of U.S. bonds by the Japanese would send U.S. interest rates through the roof.

THE FINANCIAL FAULT LINE: GERMANY \ JAPAN

The new year that opened up with unbridled optimism has already followed with an unpleasant encore of a world-wide slump in bond markets. As a result, stock markets have been infected, too. The worst devastation has been in the Japanese and American bond markets. Since mid-December, yields on 10-year Japanese government bonds have jumped some 150 basis points to 6.7% - the highest level since October 1987 - and yields on 30-year U.S. Treasuries soared from 7.8% to 8.5%.

While the Japanese bond market delivered the biggest plunge, Wall Street received the biggest surprise. It was only as recent as December that the bond "bulls" held a strong consensus. Most everybody believed that the combination of sluggish economic growth and cautious monetary easing was a sure-fire prelude to a lower underlying inflation rate. It was a foregone conclusion that long-term bond yields would head lower towards the 7.5% range on the way to 7%. As we all now know, expectations have been dashed. Why did the rosy forecasts go so wrong?

What is it that has driven up long-term interest rates? Most have a standard explanation: heightened inflation concerns caused the markets to demand higher interest rates, thereby anticipating accelerating inflation.

To begin with, we vigorously disagree with the lopsided approach that mainly relates any movements in long-term interest rates to the inflation factor. It is a ludicrous over-emphasis (and over simplification) because bond markets are subject to a variety of much more powerful influences than just these mystical inflationary expectations . . . and especially so over the short term. Rather, the most important influences that come to mind are changes in monetary policy, supply and demand, and changes in international capital flows. And today, that last factor is particularly important.

Based on that broader perspective, it is clear that the situations affecting interest rates amongst the major countries are thoroughly different. What perplexes us so much is the fact that so many interest rate forecasts never even touch upon the question of these international capital flows. Given the overriding role that cross-border capital flows have played in buoying currencies and the bond markets of the major deficit countries over the past two years such omissions are unforgivable. As it happens, international capital flows are most influential in the case of the United States, Canada and Australia.

A TWO TO THREE YEAR TREND DOESN'T MAKE A NEW ERA

During the last two years deficit countries have enjoyed unprecedented capital inflows, that being the necessary flip-side to unprecedented external deficits. Since these inflows have worked so smoothly thus far, apparently a new world of "global finance" has been borne. It's now become conventional wisdom that any size of current account deficit can be "sustained" indefinitely.

Capital mobility is the new catchword and panacea. If international capital is fully mobile, then - so the conclusion goes - countries can borrow almost endlessly. Because one country's deficit must have its counterpart in another country's surplus, fluid "global finance" beautifully counter-balances the savings imbalances.

What else can the surplus countries do with their excess savings except buy the assets of the

deficit countries? Where else can the money go? Those are the triumphant rhetorical questions posed by apostles of this New Era in which capital mobility allows ever higher accumulations of endless deficits.

It is certainly true that private capital has flowed freely from the surplus to the deficit countries. In fact, capital outflows have been so exuberant that they even exceeded current account surpluses. As such, these over-compensating capital flows had the perverse effect of depressing the currencies of the low-yield surplus countries while buoying the currencies of the high-yield deficit countries.

It appears that the comforting postulates about the propitious effects of capital mobility have even gained a following among the revered international organizations like the IMF (International Monetary Fund) and the OECD (Organization of Economic Cooperation and Development).

The trouble with all this is that when economists invent new theories, it is generally because they don't know the old theories. The introduction of capital mobility in the past few years has surely not suspended the old laws of international trade and finance. All we would say about the advent of greater capital mobility is that it gives countries a longer rope with which to hang themselves.

The apostles of "deficits without tears" (by way of international capital mobility) conveniently overlook the fact that their miraculous mechanism can cut both ways. It all depends on the relative differences of cyclical and monetary conditions in the world. Capital mobility is an enjoyable financial adrenalin for the deficit country as long as it has a strong economy that requires and tolerates high interest rates. But capital mobility becomes horrid hell for the deficit country when it has a weakening economy that requires easier money.

The worst possible scenario for the currencies and the financial markets of a deficit country is when the weakening of their economies coincides with booming economies in need of high interest rates in the surplus countries.

It's not just capital mobility that has made the financing of record-sized external deficits so extremely easy in the past years. A crucial condition was that the deficit countries had booming economies while the surplus countries had sluggish economies. These sharp cyclical divergencies allowed the large interest rate differentials that then determined the direction of capital flows. There is nothing new in this mechanism . . . much less anything that signifies the beginning of a new era.

THE WATERSHED: REVERSALS IN CAPITAL FLOWS.

The point to realize is that international cyclical conditions have now turned full circle against the deficit countries. These nations now have the weak economies and the surplus countries have the strength. It should be clear that if both Germany and Japan turn off their money spigots it would seriously jolt the financial markets of the deficit countries. These developments would slow or reverse the life-sustaining support of their capital outflows into the deficit countries.

We might remember that it was only as recent as 1987 - just three years ago - that private capital virtually ceased coming to the United States even though dollar interest rates were then 3-4% higher than German and Japanese interest rates. Over $120 billion of the $143 billion

U.S. current account deficit that year had to be financed by foreign central banks. What law of economics makes it so sure that capital must always flow from the surplus nation to the deficit countries? West Germany, having drastically tightened its monetary policy, is already exposing the fallacies of those comforting ideas about the blessings of capital mobility. The theoretical oversights are simply unbelievable. The missing link in the "new era" thinking is monetary policy. Let's elaborate on this point since it also exposes a lot of nonsense that's said and written about recent developments in Germany.

WEST GERMANY: A STUDY IN CAPITAL FLOWS.

To begin with, Germany's current account surplus in 1989 increased to DM 105 billion as compared to DM 85.2 billion the previous year. But what finally catapulted the D-Mark upward in the exchange markets, was a sudden, dramatic reversal in capital flows.

In the first quarter of 1989, West Germany still had a net long-term capital outflow of DM 33.1 billion. In contrast, by the fourth quarter of that year, it had a net inflow of a similar amount.

GERMANY: CURRENT AND CAPITAL ACCOUNT
(in $ Billions.)

	Current Account	Long-term Outflow	Capital Account Inflow	Net
1985	48.3	61.7	+ 48.8	- 12.9
1986	85.1	55.4	+ 89.2	+ 33.8
1987	81.2	62.5	+39.2	- 22.6
1988	85.2	96.3	+ 11.4	- 84.9
1989	105.0 est.	80.1	+ 65.0	- 15.1*
Oct/Nov	17.2	8.5	+ 31.5	+ 23.0

* Capital flows for the first eleven months.

Actually, foreign investors began returning to Germany in a big way during the second quarter of last year, immediately after the abolishment of the withholding tax and long before the outbreak of the new "East Euphoria". Germans themselves, however, continued to buy heavily into high-yielding foreign bonds right up to September of 1989. On balance Germany remained a net exporter of long-term capital in the third quarter, though at a sharply reduced level of only DM 6.0 billion.

Then, in October, after the Bundesbank had raised its discount rate to 6% and the lombard rate to 8%, the scenario changed abruptly. Foreign money began to flood into German bonds and stocks while German purchases of foreign securities came to a virtual standstill. In October and November, foreign investors, corporations and banks ploughed a net DM 31.5 billion into Germany by buying bonds, stocks and making loans and direct investments.

On balance, Germany registered a net inflow of long-term capital of DM 23.0 billion in those two months - a significant figure when compared with outflow of DM 33.1 billion in the first quarter and the size of the annual current account surplus. The exhibit above portrays West Germany's capital and current accounts, and puts these developments into perspective.

Despite this recent flood of funds into the German capital markets, the German bond market was very weak during that time. Ten-year government bond yields rose from 6.9% to 7.7% since early September 1989.

STAMPEDE INTO THE GERMAN BOND MARKET

As always, most people have just the one stereotypical explanation for rising long-term interest rates . . . that inflation concerns are causing investors to hold back and demand higher interest rates. The prevalent story being peddled in the markets is that the mass immigration from the East (more than 700 000 immigrants last year and probably more than a million this year) will boost the German inflation rate and public expenditures thus driving up interest rates.

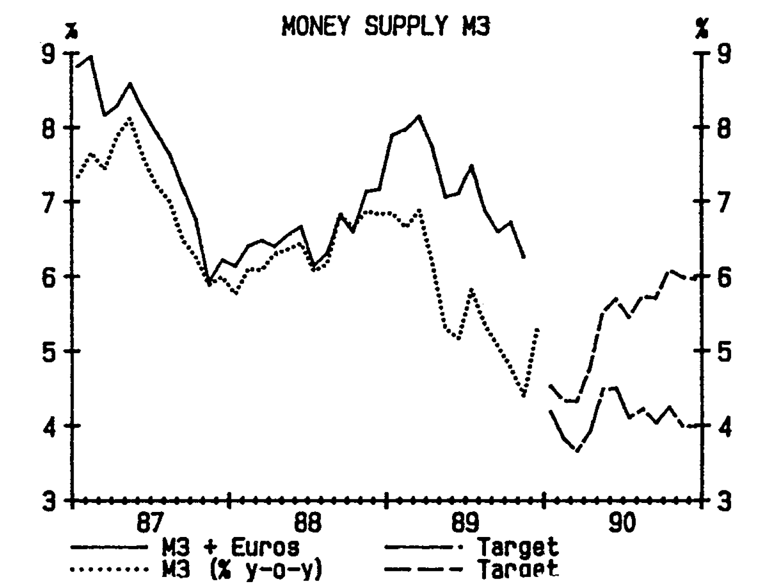
So far, the dismal performance of the German bond market seems to have proven them right. In reality, it's more a case of them being right for the wrong reasons. The irony is that domestic investors - just like foreign investors - are not holding back at all. They too have virtually stampeded into the German bond market to take advantage of the unusually high yields.

The figures are truly staggering. In 1989, net purchases of domestically issued German bonds by individual and institutional investors totalled about DM 45 billion, up from a mere DM 2.9 billion in 1988. Between April and November of 1989, foreign net purchases of such bonds soared to DM 31.7 billion, up from DM 1.9 billion in 1988. With all this incremental new demand why the rising interest rates?

What else could possibly explain the softness of the German bond market if not inflation fears? The short answer is a drastic change in monetary policy and an equally drastic shift in supply and demand for debt and credit.

First, lets review the credit demand side. A combination of sharply higher private credit demand and concentrated borrowing in the bond market led to a virtual explosion of bond issues. Net issues of medium and long-term bonds doubled from DM 41 billion in 1988 to DM 80.6 billion in 1989. In other words, growing credit demand fell disproportionately on the bond market.

WEST GERMANY



Source: Datastream

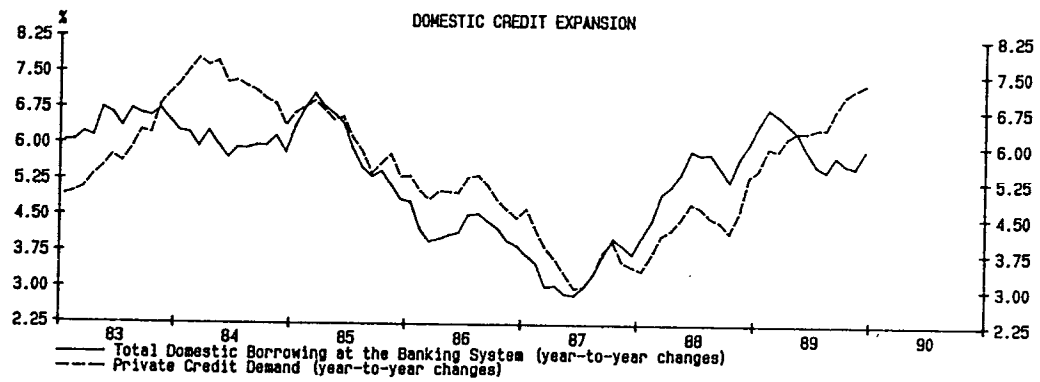
Equally sizable and important changes occurred on the supply side of the bond market. A monetary tightening and an inverted yield curve induced the banks to cut off their bond purchases, which in 1988 had accounted for over two-thirds of total bond investments. Instead, an accelerating credit

expansion was overwhelmingly met by the bond purchases of domestic and foreign investors.

The first effect of this drastic shift in credit expansion from the short to the long end of the market was markedly slower money growth. While private debt has expanded about 7% recently, M3 growth - the Bundesbank's target - has decelerated from an earlier rate of 7% to below 5%, which is within the target range (see graph on the opposite page). Considering the booming economy, the monetary picture could hardly be better.

Given the brouhaha in the markets about German inflation let's examine the relevant trends. Here, briefly, are the latest figures on a seasonally adjusted and annualized basis for the last six months. Consumer prices are up 2.3% (after peaking in April at 3%) and producer prices have slowed to a rate of 1.6% (after peaking in April at 4%). Manufacturing prices, by the way, are no higher than in 1985. In actual fact, the bulk of last year's price rises have been in food and energy. In America, those sources of inflationary pressure are always quickly discounted.

WEST GERMANY



Source: Datastream

With the German economy so buoyant and monetary policy therefore remaining tight, there is certainly little scope for easier money in Germany. In turn, all this should mean a strong and rising D-Mark against the U.S. Dollar because a weakening U.S. economy will force the Fed to further monetary easing.

The German investor, of course, stands to make zero gains no matter how high the D-Mark might rise. Yet the currency question is just as important for the domestic investor as for the foreign investor. The point of focus here, of course, turns to the potential of currency losses. Since the U.S. dollar peaked in mid-1989, a European investor based in the DM bloc has already lost approximately 20% on his long term U.S. Bonds. We think, losses might grow to 40% or more by year end.

THE WORLD ECONOMY DE-SYNCHRONISES

The inflation concerns plaguing West Germany are even more misplaced if one weighs the situation in a world context. Obviously, the many inflation-scaremongers haven't given any thought to the question of how an overheating German economy with even higher relative interest rates would impact the currency markets, particularly so the U.S. Dollar. Besides,

from the point of view of inflation, something healthy is happening to the world economy: the major economies are getting out of sync.

The manufacturing sectors of the United States, British, Canadian, Australian economies are all at the brink of recession (or already in it.) In the prevailing climate of stubborn bullishness it has gone almost unnoticed that commodity prices have fallen steeply. The fact that metal prices have suffered the steepest declines - an average of 40% against a year ago - surely reflects manufacturing weakness in some of the major countries.

Instead of worrying about inflation in Germany, we worry more and more about stagflation in the Anglo-Saxon countries and their limited options to fight a recession.

The evidence that the U.S. economy is in a cumulative slowdown is becoming more and more convincing to the alert observer - if not yet to capital markets. All the major domestic demand components have shown a clear downtrend for months. Consumer spending on cars and durables has slumped, public spending is being restrained, business profits are in the midst of a steep plunge and business investment is slowing sharply. The latter is also a function of a massive overhang in office space and other real estate property and cutbacks in defense spending. And on top of all this economic quicksand rests a continuing shake-out in the financial industry.

But so far, markets stubbornly refuse to see the big picture. Acres of statistics still obstruct the view of the forest. Whenever a single economic number comes up a little stronger than expected, it is immediately hailed as proof that the economy is bottoming out of economic weakness and that the "soft landing" and "rolling recession" scenario has won one more battle.

A typical case of this stubborn optimism was the response to the report of 0.5% GNP growth in the fourth quarter of 1989. Since the consensus forecast had been for a lesser 0.3%, the report was greeted as "better than expected". Given that these figures represent annualized rates makes such a discussion is even moor mindless and ridiculous.

On the other hand, a very significant negative in these GNP data went generally unmentioned and unnoticed: the fact that rising inventories added a full percentage point to real GNP growth. Despite the efforts to spur retail sales with promotions and price discounts, real retail trade inventories soared $15.4 billion in the fourth quarter. In effect, retail inventories were the only source of growth.

FINE-TUNING ILLUSIONS

The insatiable consumer and the Fed's fine-tuning skills remain the greatest hopes of the unbending bulls. Supposedly, continued strong income growth and high consumer confidence combined with a monetary easing by the Fed will keep the expansion going and prevent any recession . . . or so goes Wall Street's favourite argument.

We have never taken this argument very seriously. The "consumer is king" argument doesn't take into account the negative employment and income effects that result from shrinking production and investment. In fact, the way we see it, these effects are now surfacing and coming home to roost with a vengeance. Since March 1989, payroll employment has increased at a rate of less than 2%, down from a pace of 3.1% during the previous year.

We have also never shared the placid optimism concerning Mr. Greenspan's expertise in fine

tuning the economy. Until now, everybody is brimming with praise and adulation in response to the caution with which the Fed has eased. But this consenting praise will quickly turn to discredit and damnation should ever a recession comes into view.

The Fed's unusual caution, of course, has its particular reasons. The one that Mr. Greenspan likes to stress is inflation which is still uncomfortably high at 4.6% year-over-year. In reality there is a far more compelling reason and one that which Mr. Greenspan may prefer to keep silent lest he awaken any sleeping dogs. That worry is the dollar and the impact of dwindling capital inflows on the U.S. financial markets. If Japanese investors were to curtail their purchase of U.S. bonds, U.S. long-term interest rates would surely rise. Worse yet, a dumping of U.S. bonds by the Japanese would send U.S. interest rates through the roof.

In the past, when the U.S. was a major creditor nation, the Fed could muddle through a foreign exchange crisis and still afford to give priority to domestic policy matters. But, we fear, no longer. What makes the situation particularly precarious this time is the fact that the interest spreads between the dollar and the hard currencies are at their narrowest in almost 20 years.

If the fact be known, the dollar and the U.S. financial markets are at the mercy of the Japanese central bank and investors. The fate of the massive capital outflows from Japan are the single most important wild card for the dollar and the U.S. bond market.

JAPAN: THE GREAT STABILIZER OR THE GREAT SPECULATOR?

Many people seem too regard Tokyo as the ships anchor to the world's financial system. In October of 1987 and again in October 1989, when stock markets crashed around the world, Japan steadiness was one factor that helped bolster faltering confidence in the world's financial system and save it from calamity.

In our last letter we quoted a recent article in the London Economist which said: "*Thank you, Japan ... Japan has used its financial power to extraordinarily benign effect. It has been one of the main sources of stability for the world economy in the 1980s.*"

In similar fashion, the Financial Times recently hailed Japan for "*the constructive role played by the Japanese in stabilising capital markets worldwide and financing the lion's share of the U.S. trade deficit.*"

The Economist then contrasts the modern-day experience of Japanese "steadiness" as a creditor with a "financial lesson in the history books". Here they refer to America and events in the 1920s. Quoting the Economist: "*At that time, America was in much the same position as Japan is now. The first world war had turned it into the world's biggest creditor, while Britain and other European powers slid into debt. This was when American industry went international and American banks and investors rushed to lend to European borrowers. But remember how America's first creditor decade came to a close: with the Wall Street crash and, in the 1930's, the Great Depression.*"

Despite its praise of Japanese "steadiness", the Economist, however, points to the ominous parallels between Japan's present monetary and speculative excesses and the equally speculative excesses of the 1920s in America. Yet, the magazine expresses its hopes that the Japanese will not repeat the mistakes of the Americans in the 1920s. Our view is that the causes of the "Roaring Twenties" in the United States find themselves almost exactly replicated in Japan

today . . . right down to many details.

As America in the 1920s. Since 1985, the Bank of Japan has been pumping out too much money. Domestic money growth has persistently been running at a rate of 10%. This undue monetary ease is obviously designed to (1) foster domestic demand growth, (2) stabilize Japanese financial markets and (3) prop up the dollar.

On the surface the inflation situation in Japan does not look worrisome. The year-over-year inflation rate is around 3%. A large part of that rise stems from the imposition of a 3% consumption tax on April 1 last year. Since then, consumer prices have risen only 0.5% or about 1% annualized.

BOJ officials, though, are not satisfied with the inflation readings in the official indexes. Because the composition of Japanese consumption has changed quite drastically over the years, they believe that a more accurate index would show that inflation is picking up rapidly. Another area of concern is wages. Despite a tight labour market, Japan has not yet experienced much in the way of wage inflation. But with the spring wage offensive coming up soon, business expects to be confronted with demands for wage hikes in the 8-9% range.

The greatest worry of the Japanese central bank by far is the impact of this monetary looseness and credit inflation on domestic asset markets. Much of the excess money fuelled rampant speculation in Japan's real estate and stock markets sky-rocketing prices into orbit. The full effect of the monetary inflation are found in asset prices, not in the prices of goods and services.

Now comes the striking parallel to America's first creditor decade of the 1920s. Then too, monetary ease served to help an ailing currency. At that time it was the British pound that was helped by the Americans. This time the Japanese are helping the dollar. In the same fashion, what happened in October of 1927 was that the Federal Reserve Bank of New York loosened its monetary policy just when the American boom required tighter money.

There were many other uncanny resemblances to present events in Japan. Excess money poured into U.S. stocks and property causing their prices to soar. While the prices of goods and services remained stable, asset prices nevertheless exploded. Soon, however, frightened by the speculative excesses, the Fed began to tighten throughout the course of 1928/29, thus contributing to the well-known finale of the legendary stock market crash and the Great Depression.

Modern-day Exporter of Asset Inflation. And now to another major parallel only from an international perspective: Both America of the 1920s and Japan in the 1980s exported their asset price inflation around the world through massive international lending and investment flows abroad.

As a result of the combination of monetary looseness, a huge current account surplus and a wide price and yield gap between the financial and real assets of Japan and those abroad, Japanese capital flows have become a dominant force in international currency and asset markets - particularly bond and stock markets. But all of that has happened at a price: a weak yen.

Last year, two things happened that depressed the yen even further. First, Japan's current account surplus shrank substantially to $57.0 billion from $79.6 billion in 1988. But, note this

second reason: Japanese capital outflows increased sharply. Net purchases of foreign bonds rose to $94.1 billion (from $85.8 billion in 1988) and net stock purchases soared to a record $17.9 billion (from $2.99 billion in 1988). Together, net purchases of foreign securities swelled 26% to $112 billion from $88.8 billion the year before. And those figures do not include direct foreign investments which amount to another $50 billion.

Overall, Japan recorded an outflow of long-term capital of more than $150 billion in 1989, almost three times its current account surplus of $57 billion. Given this growing imbalance between the earned external surplus and long-term capital outflows, the yens weakness is, of course, a small wonder.

But this phenomenon of outflows grossly outweighing the current account is nothing new for Japan. A similar trend emerged at a modest scale in 1984 and then attained much larger dimensions in 1986. The following table shows the supporting figures.

To understand why the Japanese have become the dominating players in international markets, one has to appreciate two facts. Firstly, between year-end 1985 and year-end 1988, Japanese banks and investors augmented their holdings of foreign assets from $438 billion to $1,469 billion - an amount of over $1 trillion representing an increase of over 200%. Secondly, foreign liabilities increased at the same time from $308 billion to $1,178 billion or by $870 billion.

JAPAN: CURRENT ACCOUNT AND LONG-TERM CAPITAL OUTFLOWS
(In $Billions)

YEAR	CURRENT ACCOUNT	CAPITAL* OUTFLOWS
1985	49.1	64.5
1986	85.8	131.5
1987	87.0	136.5
1988	79.6	130.9
1989	57.0	87.9

Source: Japan Ministry of Finance
*** Represents primarily bond investment.**

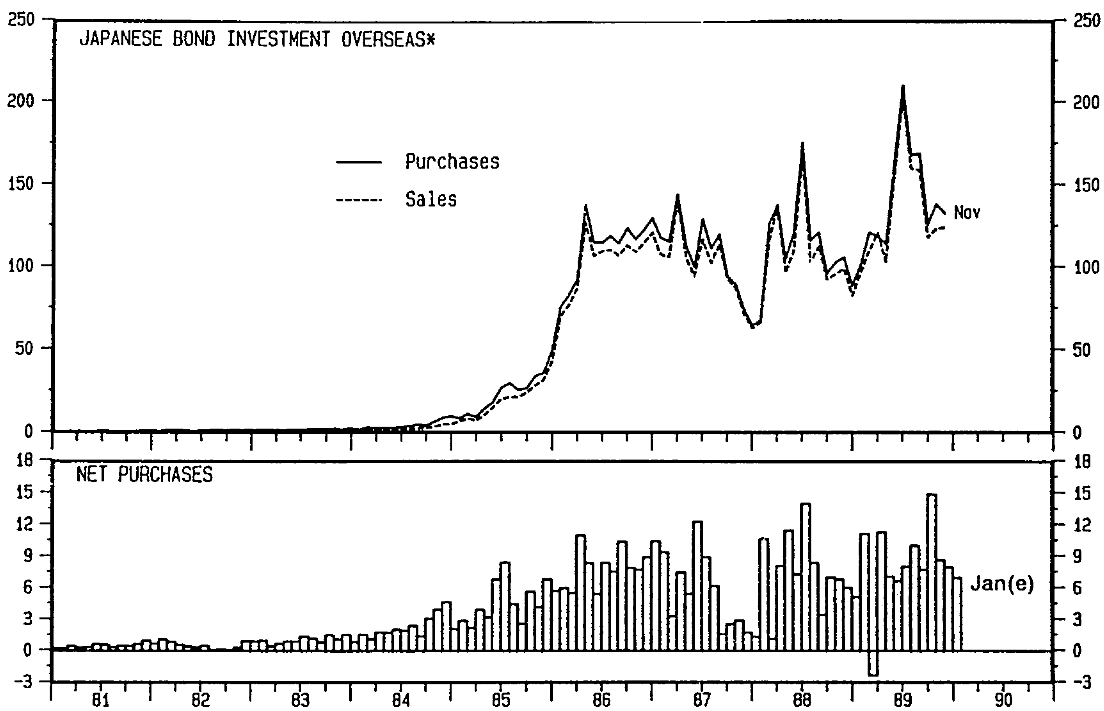
We apologize for all these statistics, but they are necessary to portray an important story. The point to see is that the greatest part of Japanese overseas investment is not covered by the country's current surplus but rather is financed by foreign borrowing (mostly short-term foreign currency borrowing.)

What these figures suggest is that the Japanese borrow heavily in foreign currencies with low interest rates - such as the D-Mark - in order to put these funds into high-yielding currencies. Last year, Japanese corporations secured vast amounts of all kinds of foreign currencies by issuing low-yielding euro-bonds with equity warrants. In this way alone, they mobilized $43 billion in foreign currencies.

The bulk of the money, both own and borrowed, is placed in dollar markets through U.S. Treasuries, euro-dollar bonds and U.S. stocks. Total Japanese net purchases of marketable U.S. bonds and stocks may have totalled near $100 billion last year. That estimate doesn't include the massive direct investments into the U.S. nor any Japanese bank loans to finance takeovers. As somebody said the other day: "*On Wall Street, everything ultimately comes back to the Japanese quotient.*"

Not only is Japan a significant holder of U.S. financial assets, but there are two other significant aspects worth noting. Firstly, a predominant portion of Japanese foreign assets are in the from of marketable and highly liquid investments, that being mostly U.S. paper.

JAPANESE INTERNATIONAL BOND TRANSACTIONS
($Billions)



Source: Japanese Ministry of Finance, Prudential-Bache Securities

Secondly, the Japanese are noted for their ferocious trading activities. According to Japan's Ministry of Finance, they purchased $1564 billion of international bonds and also sold $1475 billion through the period of January to November of 1989. The graph on this page gives some perspective on the extent of Japan's bond-trading activities.

The point to realize is that the highly fluid and liquid nature of Japan's investment in U.S. marketable securities when combined with Japan's massive dollar-base exposure virtually guarantees a highly explosive "blow-out" should ever anything go wrong. And as we have often mentioned before, any such instabilities will fall squarely on the back of currencies.

The same game has of course been played by European investors, although at a much smaller scale. The sport has been to borrow low-interest D-Marks in order to buy high-yielding U.S., Canadian and Australian dollar bonds. As German interest rates rose and the interest differential to the dollar disappeared, the balloon has quickly burst and the D-Mark has shot up as well as depressing the bonds of the high yielding countries. Could the DM-based experience be a small foreshadowing of what could eventually happen should the yen ever strengthen against the U.S. dollar?

SUMMARY CONCLUSIONS

It was the praise of Japan as the "great stabilizer" of the world's financial and currency markets that has provoked us to all these considerations. We pointedly disagree with the above statement. It's very clear what Japanese international investment is really all about.

Most people believe that they invest their large external surplus and that their investments therefore are sound and stable. To believe that is to make a gross error.

As our figures have shown, the Japanese are the most reckless borrowers within the world international markets. This borrowing clearly has no other purpose than to speculate in the currency and financial markets of other countries. So far nobody has squawked. Instead, everybody venerates the Japanese because their shenanigans have boosted asset prices in other countries.

As we have already mentioned, the Japanese have exported their domestic asset inflation. But the salient point to see is that they do it mostly with money borrowed in the Euro-market. In other words, it's a "hot money bubble" that is bound to bust at some time.

Moreover, we would stress that the Japanese are systematically depressing the yen with their persistent and irresponsible monetary expansion, thus subsidising their own industry against foreign competitors. One day the European community may retaliate against these devices. In contrast to the United States and other deficit countries, Europe is fortunately not in need of Japanese capital to support its currencies and markets. In short, instead of saying "thank you Japan", like some Anglo-Saxon nations, Europeans regard the Japanese and their financial recklessness as a threat to world stability.

One last word about Germany. German currency union and economic unification have become the new topics in the markets especially as it relates to inflation. We have already detailed how inflation and money supply have performed in Germany recently. What emerged was a splendid picture when compared to any other country in the world. Surely, a currency union will cost West Germany a considerable amount of money. But could it endanger German domestic inflation and stability? We hardly think so. After all, East Germany is a pygmy compared to the West German economy.

Reading what is written about this topic only confirms how grossly misinformed most people are about West Germany's financial strength. Compared to Germany's huge capital outflow of some DM 100 billion per annum, the potential costs of a currency union or economic unification appear quite modest. It is unlikely that the supply of capital will be problem. One has to take into account that while German capital exports halted, foreign capital has been flooding into Germany.

Publisher: Dr. Kurt Richebächer
Muehlegasse 33, CH-8001 Zuerich, Switzerland
Editor: Hahn Capital Partners

Annual Subscription:
SFr. 600.–/US-Dollar 400.– for subscribers outside Europe.

Languages: German/English